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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

December 10, 1993

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 93-251 / Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their "*Comments*" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Sherry Herauf

Enclosures

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	))))	CC Docket No. 93-251
	)	

COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Date: December 10, 1993

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SUMMARY

Pacific Bell and Nevada Bell submit their comments on the proposed affiliate transaction rule changes. We urge the Commission to reject the increased level of regulation imposed by these changes, which will significantly increase ratepayer expense without any ratepayer benefit.

The NPRM ignores both the directive of the Executive Branch to reinvent (and simplify) government and the Commission's regulatory policy favoring marketplace regulation in lieu of governmental intervention. LECs face increasing competition for interstate access. Competition should lead the Commission to reduce regulation. Instead, these rule changes increase regulation with no ratepayer benefit.

The additional safeguards proposed are unnecessary. Price cap carriers have every incentive to reduce costs in transactions with affiliates to maximize efficiency and productivity. And, price cap regulation is only one of the many safeguards established since the initial affiliate transaction rules which gives the Commission broad oversight of affiliate transactions.

Pacific Bell and Nevada Bell also discuss specific rule changes which are not in the public interest.

Tracing affiliate group costs would require tracking every affiliate's transactions with another affiliate in the event that someday, one of those affiliates were to provide an

asset or service to a regulated affiliate. Such tracking would be extremely burdensome without substantial ratepayer benefit.

The test to qualify an affiliate to use a prevailing price valuation should be reasonable and based on total company activity. Moreover, once eligibility is established, the affiliate's prevailing price should be acceptable whether it is below or above market price.

The Commission should again reject the proposal to value service transactions by comparing fully distributed costs (FDC) and estimated market value. Applying this rule to services will significantly increase carriers' administrative costs because of the number of services provided among affiliates. Moreover, requiring affiliates to pay more than FDC will result in shareholders overcompensating ratepayers. However, if FDC and market value comparison is required, the Commission should permit carriers to use reasonable informal methods to determine market value. Finally, a fair market valuation requirement should not apply to governance functions provided by the regional holding company.

Pricing services at FDC but below fair market value can benefit ratepayers and increase a carrier's efficiency by reducing ratepayers' share of a carrier's normal business activities.

Rules requiring further allocation of nonregulated amounts should be rejected. Once nonregulated costs are removed from the ratemaking process, no further allocation should be required. For example, allocation of nonregulated costs between nonregulated services to affiliates and to non-affiliates, or between nonregulated operations and nonregulated affiliates is unnecessary and will result only in additional regulatory cost without additional benefit.

Affiliate costs will be known and should be booked instead of estimates subject to true-up. Estimates and true-ups will result in higher administrative burden with no resulting ratepayer benefit.

Finally, the proposals that follow from the intent to treat nonregulated affiliate costs as regulated costs in order to determine their FDC should be modified. Nonregulated affiliates are generally competitive enterprises. Applying rules designed for monopoly companies to nonregulated affiliates can only result in tortured applications. While the Commission's desire to apply the principles behind the rules is understandable, the Commission must permit the rules to be applied flexibly because of the differences among nonregulated affiliates' accounting and business structures.

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Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	)	CC Docket No. 93-251

COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell respectfully submit their comments on the Notice of Proposed Rulemaking ("NPRM") in the above captioned docket. The NPRM proposes changes to the affiliate transaction rules adopted as part of the Part 64, Joint Cost proceeding.[1] Some of the rule changes proposed have previously been implemented by local exchange carriers upon informal direction from the Commission staff. We have implemented those changes. However, some of the proposed rule changes are not in the public interest and should not be adopted, for the reasons discussed below.

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[1] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, CC Docket No. 86-111, 104 FCC 2d 59 (1986) ("NPRM"), 2 FCC Rcd 1298 (1987) ("Report and Order"); on recon., 2 FCC Rcd 6283 (1987) ("Recon. Order"); on further recon., 3 FCC Rcd 6701 (1988) ("Further Recon. Order"), aff'd sub nom. Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

The rules for affiliate transactions arise from the Commission's concern with the potential for cross-subsidization when a regulated company deals with its nonregulated affiliates. The presumption is that the interaction will not be at arms' length. Consequently, the original Part 64 rules established rules governing the transfer of assets and services between a carrier and its nonregulated affiliates[2] in order to protect the ratepayer. Since those rules were adopted, numerous additional safeguards have been required so that today, there is a well-developed system that can detect, and thus effectively deter, cross-subsidization. The Commission should not adopt these additional proposed rules; they amount to unnecessary and burdensome micromanagement of affiliate transactions.

I. Additional Regulation Is Contrary To The Commission's Current Regulatory Goal.

A. With increased competition, less regulation is needed, not more.

The Commission has long advocated regulation by the marketplace, not by government. Marketplace competition eliminates the need for government intervention. In a competitive environment, a carrier has no incentive to cross-subsidize nonregulated activities or affiliates through affiliate transactions. Any cross-subsidization would result in

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2 The affiliate transaction rules apply only to transactions between a carrier and its nonregulated affiliates. Recon. Order at para. 122.

increased costs for the carrier which would raise the cost of its products--an unacceptable result in a competitive market.

The Commission recognizes that there is rapidly increasing competition in interstate access service. For Pacific Bell and other LECs, competition is a reality today. Competitive Access Providers (CAPs) presently provide service in each of the major metropolitan areas within California. CAPs continue to expand their networks in key locations which target Pacific Bell's high volume customers and dense traffic corridors in the Greater Bay Area, Los Angeles, Sacramento, and San Diego. In June of 1993, Time Warner AxS of California requested CPUC authorization to provide competitive access services across the state of California.[3]

Competition is not limited to California. MFS Intelnet, Inc. recently announced its first "one-stop shopping" for local and long distance services in New York and intends to provide such services in 60 to 70 cities within five years.[4] And there are other imminent competitors in addition to CAPs. Recently, five of the country's largest cable TV companies announced they will join together to develop new

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3 "Time Warner Unit Plans Cap Services in Calif.; Pacific Bell Objects," Telecommunications Reports, (BRP Publications, Washington, D.C.), June 28, 1993, at 8-9.

4 "MFS Unveils 'One-Step' Local/Long Distance Services, Plans Rollout in 60 to 70 Cities Within Five Years", Telecommunications Reports, (BRP Publications, Washington, D.C.), October 11, 1993, at 9-10.

telecommunications services that will include carrying video, data and phone service on their cables.[5]

Competition will continue to develop, in part because of the Commission policy endorsing competition. This policy is reflected by its decisions--for example, the recent decision on interstate special access expanded interconnection:

> "The Commission has taken a historic step in the process of opening the remaining preserves of monopoly telephone service to competition."[6]

The increases in competition mean that <u>reduced</u> regulation would now be appropriate. Instead, the <u>NPRM</u> proposes <u>additional</u> regulation, such as these affiliate transaction rules, which will keep the LECs at a competitive disadvantage vis-a-vis their unregulated competitors. The Commission should reject any additional regulation, take the opposite approach, and reduce the amount of government intervention.

B. The proposed rules are contrary to the intent of price cap regulation.

Price cap regulation was adopted to respond to and to foster competition. Price cap regulation developed out of the

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5 "Cable TV Firms Set Alliance", San Francisco Chronicle, December 2, 1993, at El.

6 <u>Expanded Interconnection with Local Telephone Company Facilities, Amendment of the Part 69 Allocation of General Support Facility Costs</u>, CC Docket 91-141, CC Docket 92-222, <u>Report and Order and Notice of Proposed Rulemaking</u>, 7 FCC Rcd 7369, para. 1 (1992).

Commission's justified concern that rate of return regulation does not sharpen the competitiveness of the largest LECs at the time when markets for telecommunications goods and services are becoming increasingly competitive, both nationally and internationally.[7]

One of the Commission's goals in adopting price cap regulation was to create a regulatory environment that would stimulate greater productivity. To this end, substantial increases in productivity are rewarded by permitting carriers to retain profits at reasonable levels above those permitted for rate of return carriers.[8] LECs that increase productivity and efficiency are able to retain more earnings and also share additional earnings with ratepayers. Thus, a price cap carrier has a significant incentive to reduce its costs, not to increase them, as would occur if a carrier subsidized its affiliates.

The NPRM's proposed rules for affiliate transactions will directly reduce a carrier's productivity and efficiency because they will prevent or eliminate opportunities to spread the cost of services among affiliates. A specific example of how the NPRM's proposed requirements will reduce and perhaps eliminate this avenue of productivity and efficiency is the

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7 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990), para. 28. A review of price cap regulation is scheduled for 1994. The Commission should defer the implementation of this proceeding until the review is completed. Decisions made in the 1994 review may have significant bearing on the issues raised here.

8 Id. at para. 22.

requirement for fair market comparison for goods and services provided absent a tariff or prevailing price, discussed below.

C. The proposed rules are in direct conflict with the recent Gore proposal to "reinvent government".

A few months ago, Vice President Al Gore issued his report on reinventing government.[9] The report concluded that the cost to the private sector of complying with regulation is at least $430 billion annually or 9% of our Gross Domestic Product. Vice President Gore proposed that the President direct all federal agencies to review internal government regulations over the next three years with a goal of eliminating 50% of those regulations. By the Commission' own calculation, the requirements of this NPRM will add 320,000 hours burden to carriers.[10] Thus the NPRM is contrary to the direction of the executive branch to reduce regulations. For that reason alone it should be rejected.

D. Additional safeguards for affiliate transactions are not needed.

Just two years ago, the Commission asserted that existing safeguards were adequate to justify relief from the more

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9 "'Reinvention' Plan Favors 'Electronic Government'", Telecommunications Reports, (BRP Publications, Washington, D.C.), September 13, 1993, at 25-26.

10 Public Information Collection Requirement Submitted to Office of Management and Budget for Review, Public Notice, 1993 FCC Lexis 5666, released November 12, 1993.

severe method of structural separation previously required to prevent cross-subsidization. In response to the Court's remand of the Computer Inquiry III ("CI-III") decision, the Commission concluded that structural separation was not necessary because numerous safeguards reduced the BOCs' ability to engage in improper cross-subsidization. Detailed cost allocation rules and related accounting safeguards to separate regulated service costs from nonregulated service costs, the filing and approval requirements for Cost Allocation Manuals ("CAM"), and ARMIS Reports were among the safeguards adopted. Price cap regulation also reduced an incentive to cross-subsidize.[11]

Since the CI III remand order, significant additional safeguards have been established. First, broader requirements for the CAM audit to be undertaken by independent auditors have been imposed. The CAM audit must now provide the same level of assurance for audits conducted pursuant to the Part 64 rules as that undertaken in a financial statement audit. Second, recently the Commission ordered uniform cost allocation procedures for ten accounts which contain about half of the LECs' nonregulated costs to provide the Commission with more efficient oversight.[12] Third, carriers are now required to quantify the effects of CAM

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11 Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards, CC Dkt. No. 90-623, Report and Order, 6 FCC Rcd 7571, ("CI III Remand Order"), para. 12 (1991).

12 Implementation of Further Cost Allocation Uniformity, AAD Dkt. No. 92-42, Order Inviting Comments, 7 FCC Rcd 6688, para. 6 (1992).

changes submitted to the Commission.[13] Fourth, LECs are now required to complete detailed audit spreadsheets for the CAM audit.[14] Since these safeguards provide added scrutiny of affiliate transactions, and since the Commission previously concluded that prior safeguards were adequate, we submit that even more affiliate transaction safeguards are unnecessary.

II. Specific Comments On Proposed Rule Changes

A. Tracing All Affiliate Group Costs Would Be Burdensome.

The Commission proposes to focus on "affiliate group" costs instead of on the prices affiliates pay each other.[15] The concern is that transfers among affiliates would increase costs and that unnecessary costs would be passed on to the carrier. This scenario ignores the real incentive that carriers have under price cap regulation to keep costs to a minimum. Carriers have little incentive to permit affiliates to inflate their costs.

Moreover, the administrative effort that would be required to track all "affiliate group" costs in order to be able to trace costs back to their origin would be tremendously burdensome. Every transaction between each affiliate would have

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[13] CI III Remand Order at para. 33.

[14] See, Letter from Kenneth P. Moran, Chief, Accounting and Audits Division, FCC, to S. Herauf, Director, Federal Regulatory Matters, Pacific Telesis Group (August 18, 1993).

[15] NPRM at para. 11, 48-50.

to be tracked in case an affiliate might someday sell an associated asset or service to a regulated affiliate. Implementing the tracking proposal imposes substantial resource demands, including additional personnel for both regulated carriers and their nonregulated affiliates and would not result in any ratepayer benefit.

The NPRM proposes an alternative of valuing all resources at original cost to the affiliate group regardless of whether they had previously been transferred between or among affiliates.[16] This alternative does not appear to be significantly less burdensome. Tracking will still be required to determine the original costs to the affiliate group. The Commission should not adopt a requirement for tracking but instead should rely on the very strong incentive to minimize costs provided by price cap regulation.

B. The "bright line test" should be more reasonable.

1. Seventy-five percent is an unreasonable level to establish an affiliate's primary purpose.

The NPRM intends to distinguish between nonregulated affiliates with the predominate purpose of serving nonaffiliates and nonregulated affiliates with the predominate purpose of serving affiliates.[17] In order to do so, the NPRM proposes to

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16 NPRM at para. 50.

17 NPRM at para. 21.

categorize affiliates on the basis of the percentage of each nonregulated affiliate's total output sold to nonaffiliates. If an affiliate is found to have a primary purpose of serving nonaffiliates, a carrier can record the affiliate's prevailing price for assets and services.

The NPRM proposes that a nonregulated affiliate will be found to have a primary purpose of serving nonaffiliates if 75% of a nonregulated affiliate's output is sold. That standard is unnecessarily high. As long as an affiliate has significant or substantial transactions with nonaffiliates and the carrier is charged the same price as those nonaffiliates, the Commission's concern about the carrier being overcharged as a captive audience is not warranted, and the prevailing price should be presumed to be fair.

The NPRM proposes two methods for measuring an affiliate's output to determine eligibility for using prevailing pricing for goods and services provided to a carrier.[18] Pacific Bell and Nevada Bell suggest that the alternative which determines an affiliate's qualification based on its revenues for the immediately preceding year is the preferred approach.[19] Relying on historical data instead of measuring each affiliates' output based on actual revenues during the year will provide as

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18 NPRM at paras. 82-85.

19 For a start-up company, an affiliate's qualification to use prevailing price could be established by a forecast of projected transactions.

sound a basis for determining eligibility with considerably less administrative effort.

2. The total company approach should be used if a bright line test is adopted.

The NPRM requests comments on whether a product by product approach, product line approach, line of business approach, or total company basis should be used for the proposed bright line test.

The total company approach is the most logical approach, since the bright line test is intended to determine if the affiliate's primary purpose is to serve affiliates or to serve independent markets. The total company approach is also the most efficient base upon which to apply a percentage test. Affiliates currently keep accounting records on transactions with other affiliates at the total company level so that accounting eliminations can be made properly. These accounting records are not required to be kept at the product line or line of business level. To require affiliates to keep accounting records at a level other than total company would require additional recordkeeping without any gain in benefits.

3. A carrier should be able to book a prevailing price whether it is above or below market.

A nonregulated affiliate that provides most of its output to nonaffiliated customers should be able to charge its prevailing price to an affiliated carrier whether that prevailing price is below or above market price. Cross-subsidization does not occur if the carrier is charged the same price as nonaffiliated customers. In today's competitive world, the carrier has no incentive to pay an inflated price to an affiliate.

C. The proposal to value service transactions at the higher of FDC or estimated market value should be rejected.

The NPRM proposes to require carriers to record all non-tariffed affiliate transactions for which prevailing company pricing would not apply at the higher of fully distributed cost ("FDC") or estimated fair market value when the carrier is the seller, and at the lower of cost or estimated fair market value when the carrier is the purchaser.[20] This rule, currently applicable to the transfer of assets, would be extended to service transactions.[21]

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[20] NPRM at para. 214.

[21] NPRM at para. 34. The current rule requires that carriers record affiliate transactions for services that are neither tariffed nor subject to prevailing company prices at the providers' fully distributed costs.

1. There is no reason to apply the asset transfer rules to services.

The *NPRM* proposes identical asset valuation methods for all types of affiliate transactions, whether they involve the transfer of assets or services.[22]

The heavy administrative burden of applying the asset transfer rules to services means that this proposal should be rejected. There are many transactions with affiliates involving transfers of services. For example, Pacific Bell provides approximately 100 different services to affiliates. On the other hand, asset sales or transfers to nonregulated affiliates occur much less frequently than the provision of services. Pacific Bell and Nevada Bell have only transferred or sold regulated assets to an affiliate on a few occasions since the inception of the Part 64 rules. Thus, requiring a market valuation for every service transaction will be significantly more burdensome than a comparable requirement for asset transfers.

2. In 1987, the Commission correctly rejected fair market valuation for services.

In Docket 86-111, the Commission understood the administrative issues in applying fair market valuation to affiliate service transactions. The difficulties led the

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22 *NPRM* at para. 34.

Commission to reject the use of fair market valuation for services.[23]

> "Several parties have argued that if a tariff or prevailing price list is unavailable as a measure of value, we should look to the value of similar services in the market place. We believe that such a valuation standard is fraught with the potential for abuse and would be difficult to monitor. In contrast, by requiring carriers and their affiliates to allocate costs pursuant to cost allocation standards, we can ensure that an auditable measure of the costs of the service is available."

Pacific Bell and Nevada Bell believe that the Commission was correct in 1987 and there has been no change that would support a reversal of that decision. In fact, the strengthened safeguards adopted by the Commission since the adoption of the Part 64 rules makes monitoring the allocation of costs pursuant to the cost allocation standards even easier. More stringent annual independent audits, CAM uniformity, and audit spreadsheet requirements provide additional data for the Commission's oversight. Requiring carriers and nonregulated affiliates to determine the fair market value of services should be rejected.

3. The proposal will result in a subsidy from the nonregulated affiliate to ratepayers.

The required valuation based on fair market value will disrupt the balance between shareholder and ratepayer interests

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23 Recon. Order at para. 131.

established by the Part 64 rules. If the service transaction is valued at FDC, the ratepayer is fully compensated for all of the costs the regulated entity incurs to provide the service, including an allocation of overheads and a return on investment. If a new rule requires the affiliate to be charged the higher of FDC or fair market value, the difference between the two amounts essentially becomes a subsidy by the shareholder to the ratepayer in that the nonregulated affiliate must now pay more than FDC.

4. Fair market valuation should not apply to governance functions.

The fair market valuation requirement should not apply to the governance functions provided to carriers by their regional holding companies. The holding company (in our case, Pacific Telesis Group) was not established to provide services to subsidiaries, nor does it offer or provide services to outside third parties. The holding company, as the corporate parent, represents the corporation as a whole and provides governance and other required corporate functions to its subsidiaries as part of its fiduciary duty to its shareholders to oversee its subsidiaries. Some corporate activities are required by law, such as tax filings in compliance with IRS requirements and external financial reporting in compliance with SEC requirements. Costs associated with these functions are allocated to subsidiaries in compliance with SEC, state and federal regulatory requirements. Moreover, isolating and determining the fair market value of its corporate governance functions and activities will be difficult because a number of these functions are not available in the general marketplace.

5. If market studies are required for services, reasonable methods for determining fair market price should be permitted.

If the Commission adopts a requirement that services must be valued at cost or fair market value, carriers should be permitted to use informal methods to determine fair market price. Simple methods should be acceptable to the Commission as long as they are reasonable. Formal market studies should not be required. The cost of determining the value of a transaction should be a factor considered in the decision on how to determine market value. A reasonable valuation obtained by an informal, inexpensive method (as opposed to an expensive formalized study by third parties), with appropriate documentation to support the valuation, should be acceptable. This would avoid the uneconomical use of limited resources.

D. Pricing services at FDC but below fair market value can benefit ratepayers and increase a carrier's efficiency.

The NPRM inquires as to circumstances where ratepayers might benefit or a carrier's efficiency improve if a carrier were to provide services to an affiliate at prices below fair market value but at FDC.[24]

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[24] NPRM at para. 33.

Pricing services at FDC when fair market value is greater than FDC can benefit ratepayers and increase a carrier's efficiency in some circumstances. Many functions undertaken by a carrier are essential to the carrier's normal course of business. Efficiencies are promoted by sharing the cost of these services with affiliates. For example, Pacific Bell undertakes the development and implementation of methods and procedures for Equal Employment Opportunity compliance. Pacific Bell would incur these costs whether or not an affiliate shared the service. By sharing the costs with the affiliate through FDC, efficiencies are recognized and the ratepayer benefits. FDC allows a carrier to capture its direct costs, overheads (some of which are fixed), and a return on investment. The ratepayer is made whole for the transaction. Without the affiliate's participation, the fixed overheads would only be allocated to the carrier's remaining services, the majority of which are regulated. The inability to recover some of these fixed overheads from affiliates would reduce the carrier's efficiency.

E. The apportionment of nonregulated costs between affiliate and third party transactions is unnecessary and illogical.

The NPRM asserts that the existing Part 64 rules require apportionment of the nonregulated costs used to provide nonregulated services between affiliates and non-affiliates.[25]

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[25] NPRM at para. 55.

A nonregulated product or service, whether provided to an affiliate or to a third party, is treated as a nonregulated cost for cost allocation purposes. Those costs are removed from regulated accounts for ratemaking. Thus, further apportionment of nonregulated costs is unnecessary. Further apportionment will only increase the administrative cost and burden without any resulting ratepayer benefit.

Similarly, the proposal to apply the affiliate transaction rules to transactions between a carrier's nonregulated operation and its nonregulated affiliates should be rejected. The costs of a carrier's nonregulated operation are removed from regulated accounts for ratemaking purposes. Applying the affiliate transaction rules to costs that have been removed from ratemaking can have no benefit for ratepayers. There is no logical reason to burden the nonregulated operation with rules that do not result in any ratepayer benefit. This is consistent with the Commission's position that the affiliate transaction rules do not apply when a carrier provides a nonregulated service to its affiliate and records the transaction in a nonregulated revenue account.[26]

Moreover, the attempt to extend the affiliate transaction rules to nonregulated operations and affiliates because carriers are required to account for those costs in their

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[26] United Telephone System Companies' Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, AAD Dkt. No. 90-22, Order, 7 FCC Rcd 4370, para. 12 (1992).